DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 00-0440
Income Tax
For Tax Years 1996 through 1998

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ISSUES

I. Gross Income Tax—Taxation of Reimbursements

Authority: *Universal Group Ltd. v. Indiana Dept. of State Revenue*, 609 N.E.2d 48 (Ind. Tax Ct. 1993) (*UGL* I); *Universal Group Ltd. v. Indiana Dept. of State Revenue*, 642 N.E.2d 553 (Ind. Tax Ct. 1994) (*UGL* III)
IC 6-2.1-2-2(a); IC 23-4-1-9(1)
45 IAC 1-1-54

Taxpayer protests the assessment of Indiana gross income tax on the amounts taxpayer received as reimbursements for accounting and payroll services taxpayer provided on behalf of the employees of the Partnership.

II. Gross Income Tax—Intangible Interest Income

Authority: *Indiana-Kentucky Elec. Corp. v. Indiana Dept. of State Revenue*, 598 N.E.2d 647 (Ind. Tax Ct. 1992)
45 IAC 1-1-17; 45 IAC 1-1-49; 45 IAC 1-1-51

Taxpayer protests the assessment of Indiana gross income tax on interest income received by taxpayer for financing veal farmers' purchases of veal calves, feed, and veterinary supplies.

III. Adjusted Gross Income Tax—Business/Nonbusiness Income

Authority: *Hunt Corp. v. Indiana Dept. of State Revenue*, 709 N.E.2d 766 (Ind. Tax Ct. 1999)

Taxpayer protests the Audit Division's determination that the interest income received by taxpayer for financing veal farmers' purchases of veal calves, feed, and veterinary supplies was business income subject to apportionment.

IV. Tax Administration—Abatement of Penalty

Authority: IC 6-8.1-10-2.1(d)
45 IAC 15-11-2; 45 IAC 15-11-2(c)

Taxpayer protests imposition of a ten percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana corporation that is in the business of producing and selling liquid milk replacement veal feed. An Indiana general partnership which, *inter alia*, owns, manages, and operates veal barns (hereinafter, "Partnership"), owns 97% of taxpayer's stock. Pursuant to an oral agreement entered into in 1988, and reduced to writing in 1998, taxpayer, in addition to operating its business, provides accounting and payroll services to Partnership. Pursuant to a written agreement executed in 1996, taxpayer agreed to provide accounting and payroll services to a Partnership-controlled entity, *i.e.*, a Wisconsin based limited liability company (hereinafter, "LLC"), which LLC produces dry veal feed. For providing these services, taxpayer is reimbursed by both Partnership and LLC for costs incurred. To further promote taxpayer's veal feed business, taxpayer extends credit to veal farmers under feeder finance agreements. Taxpayer receives interest income from these agreements.

The Department of Revenue conducted an audit for the years in question, and issued a notice of proposed assessments for gross income tax and interest on the amounts received by taxpayer as reimbursements for providing the accounting and payroll services to Partnership. The Department also issued a notice of proposed assessments for gross income tax on interest income taxpayer received for extending credit to veal farmers under finance agreements. Taxpayer excluded the reimbursements and the interest income from its taxable gross income. Additional facts will be supplied as necessary.

I. Gross Income Tax—Taxation of Reimbursements

DISCUSSION

In dispute is taxpayer's exclusion of the Partnership reimbursements from its taxable gross income. We do not look to the reimbursements taxpayer received from the LLC, as the Audit Division found that those reimbursements were not subject to gross income tax because they were reimbursements for work performed outside of the State of Indiana.

Indiana's Gross Income Tax encompasses most receipts of income. Pursuant to IC 6-2.1-2-2(a), "[a]n income tax, known as the gross income tax, is imposed upon the receipt of:

(1) the entire taxable gross income of a taxpayer who is a resident or a domiciliary of Indiana . . ." Except as expressly provided in IC 6-2.1 et. seq., gross income means all of the gross receipts a taxpayer receives. However, some exceptions do exist.

Taxpayers are not subject to Indiana's gross income tax on the income they receive in an agency capacity. 45 IAC 1-1-54. However, before a taxpayer may deduct such income in computing its taxable gross receipts, it must meet two (2) requirements:

> (1) The taxpayer must be a true agent. Agency is a relationship which results from the manifestation of consent by one person to another authorizing the other to act on his behalf and subject to his control, and consent by the other to so act. Agency may be established by oral or written contract, or may be implied from the conduct of the parties. . . .
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> . . .
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> Characteristic of agency is the principal's right to control the acts of the agent throughout the entire performance of the contract. This right to control cannot be limited to the accomplishment of a desired result. In addition, the principal must be liable for the authorized acts of the agent.
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> (2) The agent must have no right, title or interest in the money or property received or transferred as an agent. In other words, the income received for work done or services performed on behalf of a principal must pass intact to the principal or a third party; the agent is merely a conduit through which the funds pass.

45 IAC 1-1-54.

Taxpayer maintains that the reimbursements it receives for its accounting and payroll services are exempt from the gross income tax because an agency relationship exists between itself, as agent, and Partnership, as principal; there is no overlap or duplication of employees between taxpayer and Partnership; and, the reimbursements merely place taxpayer in the position that it would have been in had it not provided the services. Taxpayer contends that its position is best supported by an unpublished Indiana Tax Court opinion. Ind. Tax Ct. Rule 16(E) states in pertinent part: "Unless specifically designated "For Publication", such written memorandum decisions shall not be published and shall not be regarded as precedent *nor cited* before any court except for the purpose of establishing the defense of res judicata, collateral estoppel or the law of the case." (emphasis added). Although we are not a court, we, nevertheless, decline to view this case as persuasive authority as it is of no precedential value.

In determining that the reimbursements taxpayer received for accounting and payroll services were subject to gross income tax, the Department's auditor appears to rely upon *Universal Group Ltd. v. Indiana Dept. of State Revenue,* and the fact that Partnership

employees are designated in the respective management agreements with taxpayer as taxpayer employees, and are deemed to be under taxpayer's control. In *Universal Group Ltd. v. Indiana Dept. of State Revenue*, 609 N.E.2d 48 (Ind. Tax Ct. 1993) (hereinafter, "*UGL* I"), and the subsequent case *Universal Group Ltd. v. Indiana Dept. of State Revenue*, 642 N.E.2d 553 (Ind. Tax Ct. 1994) (hereinafter, "*UGL* III"), the court dealt with an affiliated group of corporations which decided to centralize some of its operations by designating one or more of the corporations to act on the behalf of the other corporations on a non-profit basis. The expenses for the operations were allocated among the corporations by formulas; and, the corporations performing the centralized operations were reimbursed for their expenses by the other corporations.

The taxpayers in *UGL* I and III maintained that the reimbursements did not constitute gross income. The Indiana Tax Court reached the opposite conclusion. The court explained that "reimbursements of a taxpayer's own expenses are receipts of gross income to the taxpayer . . . [while] [c]onversely, reimbursements to an agent for amounts advanced or paid to third parties substantively represent 'pass throughs' of income and [therefore] are not taxable to the agent." *UGL* I, 609 N.E.2d at 54. However, the court in *UGL* found that, "[t]he reimbursements to the corporations that performed the administrative tasks were reimbursements for those corporations' own expenses, such as paying their employees' wages, not for monies advanced to third parties." *UGL* III, 642 N.E.2d At 558. The court's finding was supported by the following facts: the employees performed work for the particular taxpayer as well as for the entire affiliated group, which allowed said taxpayer to benefit from its own employees' labor; the reimbursements defrayed expenses that the taxpayers receiving reimbursements otherwise would have incurred; and, but for the agreement to centralize functions, the taxpayers receiving reimbursements from the other affiliated corporations under the agreement would have had to incur the full cost of paying their employees.

We find that the facts of the instant case can be distinguished from those of the *UGL* cases. Partnership owns 97% of the stock of taxpayer. The Partnership has absolute voting control of taxpayer and controls taxpayer's board of directors. The written management agreement between Partnership and taxpayer sets forth that taxpayer will continue to provide all accounting and payroll services to Partnership, and that Partnership will reimburse taxpayer on a monthly basis for such services. Taxpayer did not receive a management fee from Partnership. Instead, taxpayer was reimbursed monthly on a dollar-for-dollar basis for the amounts it extended on behalf of Partnership. The reimbursements have never been for a predetermined amount. The amount of the reimbursements received by taxpayer vary according to the amount taxpayer expends on Partnership's behalf.

From these facts we conclude that an agency relationship exists between taxpayer and Partnership. We now turn to the question of whether taxpayer, as agent, is merely a conduit through which the payroll and accounting reimbursements pass, or a beneficiary of funds which defray expenses that taxpayer otherwise would have incurred.

Taxpayer and Partnership do not engage in the same business operations. Taxpayer produces and sells liquid milk replacement feed. Partnership operates veal barns. As stated above, the management agreement designates the Partnership employees as employees of taxpayer. And, taxpayer has complete responsibility with respect to hiring, training, supervising and discharging all employees. However, the Partnership employees work exclusively for the Partnership and perform duties for the Partnership only, just as the LLC employees work exclusively for the LLC and perform duties for the LLC only. Taxpayer is merely reimbursed by Partnership in amounts equal to what taxpayer expends in accounting and payroll services directly connected to the operation and management of Partnership's business. Partnership reimburses taxpayer on a monthly basis. Taxpayer has no right, title or interest in the payroll and accounting funds that it transfers on Partnership's behalf. Taxpayer is merely a conduit through which the funds pass.

The facts of this case lead to the conclusion that taxpayer, as agent for Partnership, is merely making payments to third parties for which taxpayer is reimbursed. As a result, the reimbursements do not constitute gross income.

FINDING

Taxpayer's protest is sustained.

II. Gross Income Tax—Intangible Interest Income

DISCUSSION

Taxpayer also protests the Audit Division's proposed assessment of gross income tax on the interest income taxpayer received for financing veal farmers' purchases of veal calves, feed, and veterinary supplies. Taxpayer's primary business is the production and sale of liquid milk replacement veal feed. In an effort to promote additional feed sales, taxpayer began extending credit to veal farmers under feeder finance agreements (hereinafter, "Agreements"). Once an Agreement is entered into, the veal farmer is provided with a veal calf, supplied with feed for the calf, and, if necessary, is reimbursed for any other expenses incurred in the raising, or "grow out", of the veal calf. While the farmer does not own the veal calf, all decisions regarding the grow out process are made by the farmer. Once the veal calf has matured (generally at the end of an eighteen-week grow out cycle), the veal calf is marketed by the farmer. Upon the sale of the veal calves, the meat packer issues a check as payment for the calves. The farmer then settles his account with taxpayer.

Out of the proceeds of the sale of the veal calf, the taxpayer retains the cost of the calf, the ordinary sale price of the feed, any other funds extended on behalf of the farmer, and interest charged at a fixed amount per calf. Any amount received upon the sale of the

calf over the sum of the initial costs is returned to the farmer as his profit. If the sale of the veal calf does not cover the amount due the taxpayer, the taxpayer becomes a creditor of the farmer for the difference.

Taxpayer maintains that the interest income it receives from the Agreements is out-of-state business income because title to all items financed by the taxpayer (excluding the dry feed, which title passes to the producer, and calves, which title never passes to farmer) pass at the location of the farmer's farm, and all items financed by taxpayer are utilized by the farmer at the farmer's farm. As such, Taxpayer contends that any and all interest income generated from Agreements with farmers located outside of Indiana should not be subject to Indiana gross income tax, but instead should be apportioned to the state in which the respective veal farmers have business situs. In short, taxpayer argues that the intangible interest income lacks Indiana situs for gross income tax purposes.

45 IAC 1-1-17 provides in pertinent part that: "'gross income' and 'gross receipts' mean the entire amount of gross income received by a taxpayer. This includes all income actually or constructively received." Here, the income in question is the interest income received by the taxpayer for financing veal farmers' purchases of veal calves, feed, and veterinary supplies. Interest income is considered an intangible for gross income tax purposes. *See* 45 IAC 1-1-51. Intangible means a personal property right, which exists only in connection to something else. *Id*. In general, receipts derived from an intangible are included in gross income. *Id*. However, determining the taxability of income from intangibles is a two part test. *Id*. (Emphasis added).

The first test, the "business situs" test, provides that if the taxpayer has established a business situs in Indiana, and "the intangible forms an integral part of a business regularly conducted at [that] situs," then the intangible has an Indiana situs for tax purposes. *Id*. The second test, termed the "commercial domicile" test, holds that if the taxpayer has established its commercial domicile in Indiana, "all of the income from intangibles will be taxed. . . except that income which may be directly related to an integral part of a business regularly conducted at a 'business situs' outside Indiana." *Id*. If the taxpayer has established its commercial domicile in another state, then "no income from intangibles will be taxed... unless the taxpayer has also established a business situs in Indiana and the intangible income derived therefrom forms an integral part of that Indiana activity." *Id*.

Pursuant to 45 IAC 1-1-49, a taxpayer may establish a business situs in ways including, but not limited to, the following:

> (1) Use, occupancy or operation of an office, shop, construction site, store, warehouse, factory, agency route or other place where the taxpayer's affairs are carried on;
>
> (2) Performance of services;

> . . .
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> (5) Acceptance of orders without the right of approval or rejection in another state;
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> (6) Ownership, leasing, rental or other operation of income-producing property (real or personal); . . .

45 IAC 1-1-49.

Taxpayer is an Indiana, for-profit, domestic corporation. Taxpayer derives income from services that are performed in Indiana, and taxpayer owns income-producing property within the State (*i.e.*, the milk replacement veal feed operations). According to the requirements set out in 45 IAC 1-1-49, taxpayer has established a business situs in Indiana.

The Department looks to the following types of activities and the location of such activities of a taxpayer to determine the commercial domicile of the taxpayer:

> . . . (1) location of management and administrative activities connected with each location . . .;
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> (2) location of board of directors' meetings;
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> (3) residence of executives and their offices;
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> (4) location of books and records;
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> (5) location of payment on income from intangibles of the taxpayer; and
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> (6) information from annual and quarterly reports of the taxpayer . . .

45 IAC 1-1-51. It is clear from the information contained in the file and taxpayer's protest letter that taxpayer has its commercial domicile in Indiana.

Although taxpayer has a business situs and is commercially domiciled in Indiana, it must be determined whether taxpayer's business situs is also the "tax situs" or "source" of its interest income. *See Indiana-Kentucky Elec. Corp. v. Indiana Dept. of State Revenue*, 598 N.E.2d 647, 662 (Ind.Tax 1992) (finding that Ohio corporation was not subject to imposition of gross income tax for sales of electricity to Indiana customers, where Ohio corporation had no tax situs within Indiana). We do this by examining whether the transactions giving rise to the intangible interest income taxpayer receives from the Agreements are an integral part of taxpayer's Indiana business activities.

For purposes of this assessment, taxpayer is involved in two types of transactions. Taxpayer's business is the production and sale of liquid milk replacement veal feed. The principal focus of the business is the sale of veal feed. To enhance its veal feed sales, taxpayer extends credit to veal farmers under feeder finance Agreements. Taxpayer's sole objective in entering into the Agreements was to increase taxpayer's feed sales. Although the actual grow out of the veal calves takes place at the respective farmers' business sites and farmers may interact with local sales and service representatives employed by taxpayer and located in the farmers' states if the farmers so choose, we believe that the facts of this case lead to the conclusion that the taxpayer's offering of the feeder finance Agreements, and the interest income that flows therefrom, are an integral part of taxpayer's Indiana business activities.

If a farmer needs additional feed for its veal calf, the farmer may contact his local representative or order additional feed directly from the LLC (seller of dry feed) or taxpayer (seller of liquid milk feed). If the farmer requests additional dry feed from the local representative, the local representative contacts the LLC and requests that the dry feed be sent directly to the farmer. Regardless of how the farmers order additional feed, taxpayer must be made aware of the additional purchases so that taxpayer can add the sale price of the feed to the farmers' accounts. Likewise, if a farmer needs medication from a veterinarian for its calves, the farmer makes arrangements with the local representative to have the cost of such medication invoiced directly to taxpayer. Upon receipt of the invoice from the veterinarian, taxpayer pays the veterinarian and adds said cost to the farmer's account. At the time of the audit, taxpayer also assisted farmers in obtaining veal calves if such assistance was requested. As part of this service, taxpayer would locate the calves, obtain the terms of their purchase from the veal producer, and forward this information to the farmer. If the farmer decided to purchase the calves, the taxpayer would arrange for the delivery of the calves from the producer directly to the farmer. Once delivery was made, the purchase price of the calves would be invoiced directly to taxpayer and added to the farmer's account. All taxpayer activities associated with the management of these Agreements occur in Indiana.

It is clear from the description of the aforementioned transactions that said transactions giving rise to the interest income taxpayer receives from its extension of credit to veal farmers are an integral part of its primary business of selling veal feed. The majority of taxpayer's sales of veal feed was generated from the Agreements. Taxpayer's extension of credit to veal farmers through the Agreements was not a one-time occurrence, rather, it was an ongoing business practice which stemmed from and promoted taxpayer's primary business goal, *i.e.*, to increase its veal feed sales. Taxpayer is the financier and sole record keeper of all of the transactions associated with the Agreements. All decisions regarding the financial aspects of the Agreements are made ultimately by taxpayer. In essence, these Agreements are negotiated, implemented, and managed by taxpayer. Furthermore, taxpayer has a business situs and is commercially domiciled in Indiana. The evidence of file clearly establishes that the transactions giving rise to the interest income derived from the Agreements are an integral part of taxpayer's Indiana business

activities, *i.e.*, selling veal feed. The auditor did not err in determining that the intangible interest income has an Indiana situs for gross income tax purposes.

FINDING

The taxpayer's protest is denied.

III. Adjusted Gross Income Tax—Business/Nonbusiness Income

DISCUSSION

During its protest hearing, taxpayer expanded its argument that the interest income it receives from the Agreements is out-of-state income not subject to Indiana gross income tax by asserting that the interest income earned by taxpayer from the finance Agreements is not allocable to Indiana, but instead is subject to apportionment. According to taxpayer, this tax, as assessed, is not fairly apportioned because it attempts to tax receipts that are derived from business transactions taking place outside of Indiana, *i.e.*, in the states in which the respective veal farmers have business situs. In support of its position, taxpayer relies upon *Hunt Corp. v. Indiana Dept. of State Revenue*, 709 N.E.2d 766 (Ind. Tax Ct. 1999), for the proposition that the interest income constitutes business income subject to apportionment, rather than non-business interest income taxable entirely by Indiana.

After an extensive review of the auditor's tax computations, we find that the only adjustment the auditor made to taxpayer's adjusted gross income (hereinafter, "AGI") was to exclude from AGI taxpayer's distributive share of income from the Wisconsin based LLC. No further adjustments to AGI were made, as the auditor determined that the apportionment reported by taxpayer (which included the interest income from the finance Agreements) was substantially correct. *See Explanation of Adjustments*, pg. 7. No error occurred here.

FINDING

Taxpayer’s protest is denied.

IV. Tax Administration— Abatement of Penalty

DISCUSSION

Taxpayer protests the imposition of a ten percent (10%) negligence penalty. Taxpayer argues that it had reasonable cause for its failure to pay the appropriate amount of tax due because said underpayment of tax was based solely upon taxpayer's interpretation of relevant statutes and regulations.

IC 6-8.1-10-2.1(d) states that if a person subject to the negligence penalty imposed under said section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty. 45 IAC 15-11-2 defines negligence as the failure to use reasonable care, caution or diligence as would be expected of an ordinary reasonable taxpayer. Negligence results from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or Department regulations.

In order to waive the negligence penalty, taxpayer must prove that its failure to pay the full amount of tax due was due to reasonable cause. 45 IAC 15-11-2. Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ." 45 IAC 15-11-2(c). In determining whether reasonable cause existed, the Department may consider the nature of the tax involved, previous judicial precedents, previous department instructions, and previous audits. *Id*.

Taxpayer has failed to set forth a basis for establishing that it exercised the degree of care statutorily imposed upon an ordinarily reasonable taxpayer. Although some of the questions raised by taxpayer involve technical issues of interpretation and applicability, given the totality of the circumstances, waiver of the penalty is inappropriate in this instance.

FINDING

Taxpayer's protest is denied.